# CHARGES IN MUTUAL FUNDS
# AND THEIR EFFECT ON THE INVESTOR'S RETURN

By

GUY JAMES WILLS III

Bachelor of Science Degree in Geography

United States Air Force Academy

USAFA, Colorado

1979

Submitted to the Faculty of the
Graduate College of the
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the requirements for
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Name: Guy J. Wills

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Scope of Study: Provide a consumer guide concerning associated costs and how they can affect the investor's return. Objectives were to: outline advantages and disadvantages of mutual funds; define difference between load and no-load mutual funds; describe other associated costs and how they affect the return; examine SEC disclosure proposals; and provide a consumer card with recommendations on what to be aware of. The study investigated the costs through professional and business publications and selected a sample size of no-load and load mutual funds.

Findings and Conclusions: The investor needs to be aware of associated charges because they can dramatically affect the investor's return. The following associated charges can be in mutual funds: loads, redemption fee, exit fee, back-end load, deferred sales charge, reloading charge, 12b-1 fee and distribution fee. Each fee can reduce the return to the investor. The additional charges are: transaction costs, operating expenses and portfolio management fees. These are relatively low and do not impact the return, however abnormal fees can be a sign of poor management or impending failure. The SEC has made it a requirement for funds to publish a charge/fee disclosure table in each prospectus reflecting how the return is affected.

ADVISER'S APPROVAL ______________________________

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# SECTION I

# INTRODUCTION

In today's financial market, the consumer faces a myriad of financial products which serve different purposes and financial goals. Mutual funds are one of the many products available to the consumer. A mutual fund is a medium through which a consumer can invest in a diversified portfolio of stocks and bonds managed by professional investment managers. Each fund is a little different, depending on its investment goals and strategies. Mutual funds are regulated by the Securities and Exchange Commission (SEC) and must operate according to SEC regulations and federal tax laws. Today there are a wide variety of mutual funds that allow investors to tailor their investment choices based on their selected financial objective and risk tolerance.

## Statement of Problem

A mutual fund can be an important part of the consumer's financial investment program. Despite the apparent simplicity of investing in mutual funds, there are several associated expenses that are not well publicized or understood by the consumer. These expenses can be of significant size and affect the overall return to the consumer. The consumer needs to be aware of these additional charges and understand how these charges can affect the investment return. This study was intended to create a reference guide for such information.

## Purpose of Study

The purpose of the study was to provide a consumer guide concerning the potential benefits and costs associated with investing in a mutual fund and how the difference effects the investor's return/yield. The objectives of the study were to:

1. Outline the advantages mutual funds offer compared against other investment choices (stocks, bonds, etc).
2. Define the difference between load and no-load mutual funds.
3. Describe the other associated charges and their costs.
4. Examine cost disclosure proposals from the SEC.
5. Create a consumer guide concerning examination of costs in mutual funds.

## Assumptions and Limitations

This study was limited by a number of assumptions and factors.

1. The study covered selected business and investment publications between period of January 1976 and March 1988.
2. Examination of mutual funds concentrated on the associated costs and did not cover the asset value of the

mutual funds.

3. The terms investor and consumer were used interchangeably.

4. This study did not intend to draw substantial conclusions from the small sample size of the no-load and load mutual funds examined, but used the sample to provide examples of costs and returns.

5. It was not the concern of this study to debate the performance of the funds selected or what particular methods each mutual fund used to compute the percentages and financial figures stated in the prospectus.

## Definitions

It was accepted that the term mutual fund encompassed various types of funds (money market, bond, common stock, etc). This study used the term mutual fund in reference to the general group. Terms used to describe the problem and the study's objectives were defined as follows:

Load charge. The sales fee that is the salesman's commission at the time of purchase of the mutual fund (Watkins, 1973).

Load fund. A mutual fund that charges a sales fee when its shares are bought (Watkins, 1973).

No-load fund. A mutual fund that sells its shares at net asset value, without any commission (Corrigan and Kaufman, 1984).

Additional Costs. Charges/fees that are indirectly incurred by the investor and necessary to the daily operation of the fund. Transaction costs, operating expenses and portfolio management fees are listed as additional costs.

Associated Costs. Costs that could be incurred by the investor. These may or may not be associated with the fund. Each fund differs and only through examination and research can these costs be determined. These costs could be front loads, redemption or exit fees, back-end loads, reloading charges, or 12b-1 fees.

12b-1 fees. Named for the SEC ruling that allows these fees. Shareholders can be charged an annual distribution fee, which covers the cost of selling or promoting fund shares. Originally designed to cover advertising and promotion costs associated with fund, these are now being used to pay fund managers for promoting the funds (Edgerton,1985).

Mutual fund. A company that invests the pooled money of a number of people (Watkins, 1973).

Objective. The reason or purpose for investing. The usual objectives are long term growth, maximum capital gains, growth and income, income preservation of capital, or a combination of several of these (Watkins, 1973).

Prospectus. An official document, usually a pamphlet, that describes new securities being offered for sale to the public. By law, a prospectus must be supplied to every purchaser. The prospectus of a mutual fund is the basic source of information about the fund. It provides information about the purpose of the fund, who runs it, how to buy and sell its shares, and a financial statement showing its investments. The prospectus will list and describe how fees/charges are assessed to the investor (Corrigan, 1984).

SEC. The Securities and Exchange Commission. The federal agency charged with regulating securities markets and the investment industry (Train, 1983). It seeks to protect the public by enforcement of the truth in security laws, by providing information, so that the investor may make an informed decision about: financial information on securities offered for public sale, financial information about securities and companies, disclosure of information about corporate matters on which stockholders are asked to vote, current reporting by management of stock holdings and short term trading profits, and penalties against fraudulent practices in the purchase and sale of securities (SEC, 1974).

## The Review Process

The study was completed in two parts.

1. A review of literature was conducted on financial fees in mutual funds by examination of selected investment periodicals that were readily available to the general public and presented a varied representation of the finance industry. The publications reviewed were: The Wall Street Journal, Changing Times, Forbes, Business Week, Barron's and Money magazine.

The period from January 1976 to March 1988 was chosen because of the availability of resources during this period. Additionally, a computer search of topics through the University of Oklahoma's Infortrac library system was used to obtain information. Over one thousand titles were searched using the subject source of investments/mutual funds. Only those articles relevant to the subject of financial fees were used for this study.

2. The second part of the study was completed by examination of selected no-load and load funds. Funds selected for this study were listed by both Changing Times and Forbes magazine in their annual ranking of mutual funds. Random number tables were used to select the funds from each magazine (Babbie, 1983). Five funds of each type were selected from each magazine (total of ten no-load and ten load funds). Ten funds of each type were used for ease of this study. The selected funds were:

TABLE I

SELECTED MUTUAL FUNDS

| No-Load | Load |
|---|---|
| AMA Income-Classic Growth | 44 Wall Street Equity |
| Babson Growth | Cardinal |
| Bull and Bear Capital Growth | Eaton Vance Income |
| Dean Witter Natural Resource | Drexel Burnham |
| Drefus Convertible Securities | Fidelity Destiny I |
| Lexington Gold | First Investors Value |
| Mutual of Omaha America | IDS Progressive |
| Nicholas II | Kemper Total Return |
| Value Line | Pioneer II |
| Vanguard Wellington | Seligman Income |

The prospectus of each fund was obtained and examined for the cost information relevant to this study. Additional information concerning mutual funds and personal investment strategies were consulted for background information.

## SECTION II

## REVIEW OF LITERATURE

The concept of a company that invested the collective assets of investors dates back to the eighteenth century. According to Sargeant (1982), one of the first recorded mutual funds was the New England Life Insurance company in 1823. The New England Life Insurance company possessed features that resembled present day mutual fund companies. In the early 1920s, the mutual fund company became established in the financial world and offered the consumer a chance to invest in the financial market and cut risk through diversified investments. In 1929, there were nineteen mutual funds with assets of about $140 million. By 1982, mutual funds had grown to approximately a $275 billion industry (Sargeant, 1982). In 1986 alone, more than 400 new funds were established. According to the Lipper Analytical Services, a mutual fund ranking service, over the last ten and fifteen years, equity funds on the average, outperformed the Standard & Poor's 500 stock index and Dow Jones Industrial Average. However, performance alone does not explain the booming business in mutual funds. New investors were coming into the market every day. While the following reasons do not fully explain why mutual funds were popular, it does present some reasons why mutual funds continue to be a popular choice of the investor.

1. The Baby Boom generation was turning 40 and beginning to think about saving and investing for a college education for their children.

2. There were more two income families, who had income available to invest.

3. Sophisticated and widespread information about financial products was readily available and reaching potential investors.

4. Money market funds, became the major investment vehicle for millions of investors, and this opened the door for other types of mutual funds.

5. Double digit inflation and interest rates made investors more sophisticated about investments in an attempt to receive better yields on their money.

## Mutual Fund Features

The advantages of a mutual fund, whether it is a load or no-load are many. The main advantages according to Porter (1975) and Watkins (1973) are:

1. Professional Money Management. Probably the primary benefit of a mutual fund. With professional management the consumer potentially could receive the benefits of a professional investment team, backed by facilities for statistical analysis and economic research.

2. Diversification. A typical fund spreads the risk over many different company stocks and securities. A

disaster in any one or two of them would only have a small effect on the fund.

3. No Emotional Entanglements. Investing in a mutual fund cuts down on the emotional involvement with a company or industry sector when the consumer buys, sells or suffers a loss with the fund's shares.

4. Investment Flexibility. A consumer can invest as little as $50, and additional sums can be invested at any time. The investor could create an investment program where a set dollar was invested on a regular schedule (also known as dollar cost averaging).

5. Automatic Reinvestment of Dividends and Capital Gains. Annual dividends and other earnings can be automatically converted to additional shares in the fund.

6. Reduced Study and Homework. The consumer need only spend a fraction of time and effort to choose a fund and keep abreast of its fortunes, compared with the time needed to run a stock-market portfolio.

7. Simplified Record Keeping. Mutual funds send investors information listing the total dividends and other distributions made during the year. The status and value of the account can be determined in a moment. Another plus for the investor, is that the mutual fund does away with the fuss and bother of safe-keeping of individual stock and bond certificates.

8. Securities and Exchange Regulation. Mutual funds are policed and controlled by the Securities and Exchange

Commission (SEC).

9. Liquidity. Consumers have the ability to sell some or all of their shares back to the mutual fund at a moment's notice (Mutual Fund Forecaster, Part IV).

## Load and No-Load Funds

All mutual funds can be divided into two types, load and no-load. If the consumer bought shares with the help and advice of a sales person or broker, and paid a sales commission, then it was a load. This charge is also referred to as a front load. A typical load or sales commission is approximately 8.5% of the consumer's total investment. This meant, if the consumer invested $1000, then $85 would be deducted for the sales fee/commission, and $915 would be invested in the fund (Watkins, 1973). By law, 8.5% is the maximum charge, however, funds that have a systematic savings plan are allowed to charge higher loads. Investors who make fixed monthly payments are charged up to half the first year's payments as a sales and creation charge (Consumer Reports, June 1987).

With a no-load fund, consumers would have to seek out and buy shares themselves directly from the fund. There would be no sales people or sales charges, thus it has no front load.

However, the consumer must be aware of the true no-load fund. If a no-load fund charges a 12b-1 fee (hidden load), is it a no-load fund? The No-Load Mutual Fund

Association says, that both no-load and load funds may adopt 12b-1 fees. This fee is used to pay advertising and marketing costs, and is clearly explained in the prospectus. Before the 12b-1 fee can be used in each fund, it must be voted and adopted by the investors of that fund (Mutual Fund Forecaster, December 1987). The question is whether a 12b-1 fee is a load? A load is a sales commission paid up front to the broker or sales person as an initial charge. The 12b-1 fees are also used to pay sales persons and brokerage firms for selling the fund. Therefore, a fund that pays 12b-1 fees is charging a load.

## Fund Performance

A key question for consumers is which type of funds are better, load or no-load? According to Corrigan (1986), sale charges or commissions have nothing to do with the performance of the fund. The performance records of both types of funds are about the same. However, according to Consumer Reports (June 1987), no-load funds out performed load funds in 1987. Springer (1986) stated that on the whole load funds performed no-better than no-load funds. The study found that every article had a different opinion on which fund performed better. Each article examined the funds differently, such as what type funds were examined, for what period of time, what performance factors were considered. In short, a case might be made for either side, dependent on what was examined and how the information was analyzed. The following table, extracted from the Mutual Fund Forecaster newsletter special report attests to the performance of growth and income funds:

TABLE II

PERFORMANCE: NO-LOAD VS LOAD

GROWTH AND INCOME FUNDS
ANNUAL RATES OF RETURN: 1971-1985

| | No-Load Funds Only | All Funds |
|---|---|---|
| 1971-1975 | + 3.2% | + 3.8% |
| 1976-1980 | +16.5% | +15.9% |
| 1981-1985 | +15.1% | +13.8% |
| average all 15 years | +11.6% | +11.2% |

Neither type fund can claim an advantage. The load funds claim that, thanks to the load, the funds are sold more vigorously, and thus tend to become larger than no-loads. Their greater size ultimately leads to lower expense ratios, and therefore, more dollars invested for the investor (Mutual Fund Forecaster, November 1987). However, studies have examined the correlation between the size of the fund and its performance. The universal conclusion according to one source was that big is not better (Mutual Fund Forecaster, Part I). Large fund family's do not necessarily mean better performance. Large funds are constrained by their sheer size to invest in highly capitalized stocks which are generally among the least volatile in the marketplace. Smaller funds can be more flexible and have the opportunity to manage its portfolio in a superior manner. Either way, the investor must decide on which type to purchase, especially if the performance of both types of funds are the same.

The real question should be, why pay a sales charge? The answer is not clear. It is a personal decision. Just as some consumers go to the self-service gas pump, others are willing to pay extra for that same gasoline in order to get full service (Corrigan, 1986). If the consumer does not have the aptitude or time to do the homework in selecting the best fund, then there is the service of a salesman or broker. However, the fact that a salesman was used to purchase the fund, consumers must remember this was more of a convenience factor, and not a guarantee of fund performance. Many times the sales technique of the individual salesman closes the transaction.

## SECTION III

## RESULTS AND ANALYSIS

The intent of this study was to create a guide for the investor about possible charges associated with mutual fund investing. The results are listed in two areas: (1) associated costs and (2) additional costs. In each of these areas, applicable examples were listed to show the effect on the investment dollar. Also, if the sample load and no-load funds had similar associated costs, these too were listed. Finally, future SEC actions and how they would aid the investor were listed.

### Associated Costs

The study collected the following information on associated costs when investing with mutual funds. Not all were applicable to each mutual fund.

1. Load/Sales Charge. Some mutual funds imposed a sales charge or load to investors who bought new shares. The maximum sales charge at the offering price is 8.5%. The maximum sales charge at the amount invested is 9.3%. Therefore, sales charges range up to 9.3%, although the maximum charge published was usually 8.5%. If the price per share was $1,000, then assuming the maximum sales charge of 8.5%, after subtracting the sales charge of $85, $915 would

be invested into the fund. The 8.5% of the offering price ($85) equals 9.3% of the amount invested (9.3% x $915 = $85). What does this mean to the investor? Not much. Remember, all mutual funds quoted their sales charges as a percentage of the total cost of the shares purchased plus the commission, 8.5% of $1000 = $85 sales charge ($915 invested).

The study's sample group of load funds had the following load percentages. This chart assumes a 10% growth rate each year and shows the effect of the load after one, five and ten years:

TABLE III

SELECTED FUNDS LOADS

| $10,000 initial investment | | 1 yr | 5 yrs | 10 yrs |
|---|---|---|---|---|
| no-load | 0% | $11,000 | $16,105 | $25,937 |
| 44 Wall Street | 1.0% | $10,890 | $15,944 | $25,678 |
| Drexel Burnham | 3.5% | $10,615 | $15,541 | $25,029 |
| Eaton Vance | 4.75% | $10,477 | $15,340 | $24,705 |
| Seligman Income | 4.75% | $10,475 | $15,340 | $24,705 |
| IDS Progressive | 5.0% | $10,450 | $15,299 | $24,640 |
| Mass Investors | 7.25% | $10,202 | $14,937 | $24,056 |
| Cardinal | 8.5% | $10,065 | $14,736 | $23,733 |
| Kemper Total | 8.5% | $10,065 | $14,736 | $23,733 |
| Fidelity Destiny | 9.0% | $5,005 | $7,327 | $11,801 |

Loads charged may be higher than 8.5% because the SEC allowed those mutual funds with a systematic saving plan (investors make a fixed monthly payment) to charge up to half the first year's payments as a sales and creation charge. Fidelity Destiny I is a front load mutual fund and charged 9.0%. If an investor invested $100 per month in this fund, $50 would go to the fund to pay for costs (sales and creation charges), then the remainder of the $100 ($50) would be invested into shares of the fund. In the first year this would equal $600 for sales and creation charges and $600 invested into share of the fund. The following table shows a 10% annual return for one, five and ten years. Remember, that 50% of the first years investment is taken off the top.

TABLE IV

RETURN: NO-LOAD VS FRONT LOAD

| $10,000 initial investment | 1 yr | 5 yrs | 10 yrs |
|---|---|---|---|
| no -load | $11,000 | $16,105 | $25,937 |
| Fidelity Destiny | $5,005 | $7,327 | $11,801 |

2. Redemption Fee or Exit Fees. When the investor sold/redeemed shares of the mutual fund, they would incur another charge. Fees ranged from 1% to 5.3%. Some fees were imposed just to discourage investors from frequent trading. These fees would be charged at the time shares were bought or when the shares were redeemed. This type fee was common with sector funds (Consumer Reports, June 1987). The following chart assumes a 10% annual rate of return, as shows the effect of a 1% and 5% exit fee:

TABLE V

RETURN: NO-LOAD VS EXIT FEE

| $10,000 initial investment | 1 yr | 5 yrs | 10 yrs |
|---|---|---|---|
| no-load | $11,000 | $16,105 | $25,937 |
| 1% exit fee | $10,890 | $15,944 | $25,678 |
| 5% exit fee | $10,450 | $15,299 | $24,640 |

3. Back-end Loads. Similar to exit fees, these deferred sales charges are intended to discourage frequent sales. They were scaled back each year until, perhaps after the sixth year of share ownership, they disappeared. Loads ranged as high as 6% for the first year (Boronson, 1987). The following chart assumes a 10% annual growth rate, and compares a no-load return without exit fees to a fund with a 5% decreasing back-end load.

TABLE VI

RETURN: NO-LOAD VS BACK-END LOAD

| $10,000 initial investment | No-load | Redeemed |
|---|---|---|
| 1st yr (5%) | $11,000 | $10,450 |
| 2nd yr (4%) | $12,100 | $11,616 |
| 3rd yr (3%) | $13,310 | $12,910 |
| 4th yr (2%) | $14,641 | $14,348 |
| 5th yr (1%) | $16,105 | $15,943 |
| 6th yr (0%) | $17,715 | $17,715 |

The study's sample group of no-load and load funds had two mutual funds in each that charged either a redemption, exit or back-end fee. The following chart summarizes the redemption, exit, and back-end fees examined in the study group.

TABLE VII

SELECTED FUNDS REDEMPTION, EXIT, BACK-END FEES

| No-Load Mutual Funds | Redemption/exit back-end |
|---|---|
| AMA Income-Classic Growth | No |
| Babson Growth | No |
| Bull and Bear Capital Growth | No |
| Dean Witter Natural Resource | Yes |
| Drefus Convertible Securities | No |
| Lexington Gold | No |
| Mutual of Omaha America | No |
| Nicholas II | Yes |
| Value Line | No |
| Vanguard Wellington | No |
| **Load Mutual Funds** | **Redemption/exit back-end** |
| 44 Wall Street Equity Fund | Yes |
| Cardinal | No |
| Eaton Vance Income | No |
| Drexel Burnham | No |
| Fidelity Destiny I | Yes |
| First Investors Value | No |
| IDS Progressive | No |
| Kemper Total Return | No |
| Pioneer II | No |
| Seligman Income | No |

4. Reloading Charge. The majority of funds permitted the investor to automatically reinvest all capital gain and income distributions in new shares with no sales charge. However, some funds would add a reloading charge on reinvestments of capital gains distributions (Mutual Fund Forecaster, Part III). The maximum permissible quoted reloading fee was 7.25% of the total amount reinvested. If a fund paid $100 in capital gains distribution, and investor wanted to reinvest, the fund would keep $7.25 and reinvest

$92.75 in new fund shares.

5. <u>12b-1 Fee or Distribution fees</u>. The SEC in their effort to control hidden loads created the 12b-1 fee. Mutual funds were growing at a tremendous rate and so were the costs. The intention of the 12b-1 fee was to pay advertising and marketing costs. However, the SEC did not impose any limitations on the amount or how the fee could be imposed. The 12b-1 fee took a portion of the shareholders' assets (both new and existing shareholders) and paid sales and promotional expenses, as well as, salesmen and others as compensation for selling the fund. The fee could range from .25% to 1.25% annually. The following chart extracted from <u>Sylvia Porter's Personal Finance</u> magazine (May 1987) showed how a 1% 12b-1 fee would effect an initial investment of $10,000:

TABLE VIII

RETURN: NO-LOAD VS 12B-1 FEE

| $10,000 initial investment | 1 yr | 5 yrs | 10 yrs |
|---|---|---|---|
| no-load | $11,000 | $16,105 | $25,937 |
| no-load with 1% 12b-1 fee | $10,890 | $15,315 | $23,457 |

Before the fund could charge 12b-1 fees, the share holders must have voted and approved the use of the fees. Even then, some funds do not impose the 12b-1 fee. The investor must realize that the 12b-1 fee could possibly incur a higher cost than a load. Load fees were charged once, during the initial purchase. The 12b-1 fee was charged annually, and therefore reduced the investors return (Consumer Reports, June 1987).

The study's sample group had nine funds that listed 12b-1 fees in their prospectus. The following table summarizes the data:

TABLE IX

SELECTED FUNDS 12B-1 FEES

| No-load Mutual Funds | 12b-1 Fees |
|---|---|
| AMA Income-Classic Growth | Yes |
| Babson Growth | No |
| Bull and Bear Capital Growth | Yes |
| Dean Witter Natural Resource | Yes |
| Drefus Convertible Securities | Yes |
| Lexington Gold | Yes |
| Mutual of Omaha America | No |
| Nicholas II | No |
| Value Line | No |
| Vanguard Wellington | Yes |
| **Load Mutual Funds** | **12b-1 Fees** |
| 44 Wall Street Equity | No |
| Cardinal | No |
| Eaton Vance Income | No |
| Drexel Burnham | No |
| Fidelity Destiny I | No |
| First Investors Value | No |
| IDS Progressive | Yes |
| Kemper Total Return | Yes |
| Pioneer II | No |
| Seligman Income | Yes |

## Additional Costs

Additional costs were usually harmless and relatively low. They were indirectly incurred by the investor. Nevertheless, the informed investor should be aware of these additional costs.

1. <u>Transaction Costs</u>. As a fund bought and sold shares, it incurred brokerage commissions. Transaction costs were normally lower for mutual funds because they bought and sold in large quantities.

2. <u>Operating Expenses</u>. These included various daily operating costs, including rent, telephone expenses, prospectus and annual report printing, etc. These were normally paid from fund assets and did not effect the investors return. Typical expenses range from 0.25% to 1% per year.

3. <u>Portfolio Management Fees</u>. Every mutual fund contracted with a portfolio management firm that handled investment decisions. The fee paid to the manager, usually ranged from 0.25% to 1.5% of the fund's assets. Pioneer II fund management's fee was:

- .50 of 1% of the funds average daily net assets up to $250 million.
- .48 of 1% of the nest $50 million.
- .45 of 1% of the excess over $300 million.

This fee was computed daily and paid monthly. Generally, the larger the fund, the lower the percentage rate. Each fund in the study computed the management fees differently. Usually they are of minimum concern to the investor, since they are distributed against all shares in the fund. If they're running as high as 4% to 5%, this may be an indication of poor management (<u>Consumer Reports</u>, June 1987).

## FUTURE SEC ACTIONS

In August 1987, the SEC proposed a rule to require mutual funds to list all recurring and nonrecurring expenses in a single table in the forepart of the prospectus. Also required would be a table illustrating the impact of those expenses on a hypothetical $1,000 investment held one, three, five or ten years, with an assumed 5% return (Mutual Fund Forecaster, January 88). The following table was developed by the Mutual Fund Forecaster to illustrate what could possibly be created:

TABLE X

PROPOSED PROSPECTUS TABLE

Dean Witter Developing Growth Securities
Nonrecurring Shareholder Expenses

| | |
|---|---|
| 1. Sales Load Imposed on Purchase............. | None |
| 2. Deferred Sales Load (as a percentage of lesser of original purchase price or redemption proceeds).......................... | 5% |
| 3. Redemption Fee............................ | None |

Recurring Fund Expenses During the Past Fiscal Year
(as a percentage of average net assets)

| | |
|---|---|
| 4. Management Fees........................... | 0.50% |
| 5. 12b-1 Fees................................ | 1.00% |
| 6. Other Expenses............................ | 0.30% |
| 7. Total Expenses............................ | 1.80% |

Redemption Value of $1000 Initial Investment

| Holding Period | 0% Annual Return; Less Expenses | 5% Annual Return; Less Expenses | 5% Annual Return; No Expenses |
|---|---|---|---|
| 1 yr | $933 | $981 | $1050 |
| 3 yrs | 919 | 1066 | 1158 |
| 5 yrs | 895 | 1146 | 1276 |
| 10 yrs | 834 | 1358 | 1629 |

The table showed that this fund had a decreasing deferred sales charge of 5.0% for the first year, then decreasing to zero after six years (steps 1-3). Refer to TABLE VI to see the effect upon the investor's return. Under recurring expenses, there was a 1.0% a year hidden load that resulted in 1.8% per-annum total expenses ratio (steps 4-7). Refer to TABLE VII to see the effect upon the investor's return.

When the investors compares the 5% columns, the following information should become apparent:

-Assuming 5% return and redemption costs (nonrecurring and recurring costs):

| | |
|---|---|
| 1 yr | $69 in expense costs |
| 3 yrs | $92 in expense costs |
| 5 yrs | $130 in expense costs |
| 10 yrs | $271 in expense costs |

-Assuming that the redemption fee was not applied (only recurring costs applied):

| | |
|---|---|
| 1 yr | $19 in expense costs |
| 3 yrs | $61 in expense costs |
| 5 yrs | $111 in expense costs |
| 10 yrs | $271 in expense costs |

The numbers that should stand out to the consumer, were that the fund's growth, over the first three to ten years, was eaten by fees and expenses.

In January 1988, the SEC unanimously adopted this proposal requiring mutual funds to disclose all fees and expenses in a single table. For funds with back-end loads, the table would show costs if the shares were redeemed. The SEC also ordered that funds describe their 12b-1 hidden load distribution plans in greater detail, including information on how they spent the monies collected from hidden loads

(<u>Business Week</u>, 15 February 1988).

# SECTION IV

# SUMMARY, CONCLUSION, AND RECOMMENDATIONS

## Summary

Selecting a mutual fund is not as easy as it appears. The investor must consider each fund on its own merits and do some preliminary work, such as choosing an objective that meets future financial goals. This study has shown that the next step should be the careful examination of the prospectus to discover what fees were charged. Unexpected fees could lower the return a considerable amount. Some fees were normal such as the management, operating and transaction costs for daily operation. However, the investor must be aware of abnormal fees and expenses. These could indicate poor management and troubled times.

Of the selected mutual funds, loads ranged from 1.0% to 9.0%. The study did not compare performance of the funds against the loads charged. The study did state that performance of no-load funds and load funds were similar when compared against each other as a group (Table II). However, the study also concluded that there were different opinions from every article researched, each claiming an advantage for or against no-load and load funds. The study collected no real evidence supporting the performance question of load verses no-load funds.

Four mutual funds, charged a redemption, exit, or back end fee. This fee appeared to be charged more in sector funds, where fund switching was more prevalent and tied to the ups and downs of the economy (Table IV, Table V and Table VI).

Of the selected mutual funds, a reloading charge was not discovered. However, this fee does exist in the financial world and can effect the return to the investor, dependent upon the frequency (quarterly, semi-annually, etc), what percentage is charged, and the amount reinvested.

TABLE XI

SELECTED MUTUAL FUND SUMMARY

| NO-LOAD | LOAD | 12B-1 | Redemption,exit, back-end |
|---|---|---|---|
| AMA Income-Classic Growth | NL | Yes | No |
| Babson Growth | NL | No | No |
| Bull and Bear Capital Growth | NL | Yes | No |
| Dean Witter Natural Resource | NL | Yes | Yes |
| Drefus Convertible Securities | NL | Yes | No |
| Lexington Gold | NL | Yes | No |
| Mutual of Omaha America | NL | No | No |
| Nicholas II | NL | No | Yes |
| Value Line | NL | No | No |
| Vanguard Wellington | NL | Yes | No |
| **LOAD** | **LOAD** | **12B-1** | **Redemption.exit back-end** |
| 44 Wall Street Equity | 1.0% | No | Yes |
| Cardinal | 8.5% | No | No |
| Eaton Vance Income | 4.75% | No | No |
| Drexel Burnham | 3.5% | No | No |
| Fidelity Destiny I | 9.0% | No | Yes |
| First Investors Value | 8.5% | No | No |
| IDS Progressive | 5.0% | Yes | No |
| Kemper Total Return | 8.5% | Yes | No |
| Pioneer II | 8.5% | No | No |
| Seligman Income | 4.75% | Yes | No |

The 12b-1 fee existed in nine of the funds. This fee could incur a higher cost than a load and reduce the return a considerable amount (Table VIII). The table below summarized how a load and a 12b-1 fee effected the return to the investor. This table assumed a 10% annual return (Combined from Table III and Table VIII).

TABLE XII

NO-LOAD VS LOAD VS 12B-1 FEE

| $10,000 initial investment | 1 yr | 5 yrs | 10 yrs |
|---|---|---|---|
| no-load | $11,000 | $16,105 | $25,937 |
| no-load with 1% 12b-1 | $10,890 | $15,315 | $23,457 |
| 3% load | $10,670 | $15,622 | $25,159 |
| 8.5% load | $10.065 | $14,736 | $23,733 |

The table compared the return of the no-load with 12b-1 fee against the 3% and 8.5% load fund. The no-load fund established the maximum return. In the fifth year, the 3% load fund had a higher return when compared against the 12b-1 fee fund and the 8.5% fund. Finally, the tenth year showed the 3% and 8.5% load funds produced a higher return than the no-load fund with a 12b-1 fee. The cause was the 12b-1 fee was applied each year, yet the 3% and 8.5% load was a one time initial fee. Therefore, a mutual fund with an imposed 12b-1 fee could be more costly to the investor dependent on the length of time.

The study also examined the prospectus of each fund and found each prospectus was a challenge to read. The load charged was easily determined and clearly stated. The management, operating and transaction costs were clearly stated. These generally decreased as the funds net assets grew. However, it was difficult to comprehend, the actual dollar amount spent on such items. Redemption, exit, and back-end fees were easily and clearly spelled out such as, may redeem shares without any charge. Finally, 12b-1 fees, while they appeared in almost 50% of the funds, were usually listed under management or distribution agreements. Each fund used this fee to pay for different items and listed such in the prospectus. Although the prospectus was required by law to be provided to each investor prior to investment into the fund, the prospectus' were not easily understood.

Finally, the SEC made it easier for the investor. The new financial tables to be included in each prospectus should enable the investor to see where and what could be expected as far as financial charges and possible returns. It should become another tool for the investor to evaluate each fund.

## Conclusion

This study was designed to create a consumer guide for the investor about additional charges relating to mutual funds, and how they could affect the investment return. Review of the literature indicated that there were several possible charges/fees that were not clearly explained to a potential investor. These charges were reported in the prospectus of the mutual fund, yet how they affected the return were not explained. This study tried to explain and show how these charges could affect the investors return.

The study's first objective was to outline the advantages mutual funds offer. The study listed nine advantages that appeared common to most publications and journals. The overall reason was that mutual funds offered an easy and worry-free investment method, offering diversified financial objectives and opportunities for the consumer. Mutual funds could be compared to a financial one-stop shopping mall.

The second objective of the study was to define the difference between load and no-load mutual funds. The load mutual fund charged a fee for purchased shares through a broker or sales representative. The investor paid the salesman for his time and work. No-load funds were purchased directly from the company, and the investor paid no middle man. Load charges were one time fees for the initial purchase of shares.

The third objective was to describe other associated charges that can affect the return to the investor. There were several charges to the investor that could reduce the return if imposed. All such charges were listed in the prospectus. Redemption fees, exit fees and back-end loads were very similar, in that there was an imposed fee for redeeming shares or exiting the fund prior to a set period of time. Reloading charges was another such fee imposed on investors. In the majority of funds, reinvestment of capital gain and income distribution were automatic. However, a fund with this type charge would assess a reloading fee for the reinvestment of dividends and capital gains. This study did not find a fund that imposed such a fee. The charge that appeared in most of the funds was the 12b-1 fee. The fee was allowed by the SEC to initially pay for the increased advertising costs associated with the funds. However, both no-load and load funds were using 12b-1 fees to pay brokerage firms for their effort in promoting the fund (cleverly worded, this meant a commission was paid for selling the fund). The 12b-1 fee could incur a higher cost to the investor (reducing the yield/return to the investor) because this fee was charged annually. Finally, other additional cost in mutual funds were transaction, operating expenses, and portfolio management fees. While these fees were necessary for the daily operation of each fund, they were usually low. The investor must be aware of an abnormal charge, for it could indicate poor management and impending financial trouble.

The fourth objective of the study was to examine cost disclosure proposals for the future. The SEC approved in January 1988, that each mutual fund establish a detailed financial table in each prospectus, listing all recurring and nonrecurring expenses. This table would list a hypothetical $1,000 investment showing a assumed growth of 5% for a one, three, five and ten year period, and how the expenses would effect the potential return. This move by the SEC would aid each investor in reading the prospectus and realizing the effect of the associated charges. However, interpretation of the facts and figures was still left to the investor.

The final objective of the study was to create a consumer guide concerning examination of costs in mutual funds. The following summary of charges intended to aid the consumer in this endeavor.

- LOAD CHARGE: a sales charge or commission paid to the broker or sales person

  -- maximum 8.5% of offering price.
  -- paid on each initial purchase of shares.
  -- load funds do not guarantee performance.
  -- front load-commission is taken from top and the remainder invested.
  -- back load-commission is taken when shares are redeemed.

- NO-LOAD: mutual fund that is bought directly from the company. Does not pay a commission or sales charge.

  -- no-load funds do not guarantee performance.
  -- entire investment purchases shares of the fund.

- REDEMPTION FEE OR EXIT FEES: applied when the investor redeems or cashes in shares.

  -- common to sector funds.
  -- range from 1% to 5.3%

- BACK END LOADS OR DEFERRED SALES CHARGE: applied if the investors tries to redeem shares prior to a set period of time.

  -- used to discourage frequent trading.
  -- normally scaled back each year.

- RELOADING CHARGE: applied to reinvestment of capital gains.

  -- normal reinvestments of capital gains is automatic.
  -- new charge, very few funds apply this fee.
  -- maximum reloading fee is 7.25% of total amount reinvested.

- 12B-1 FEE OR HIDDEN LOAD: SEC approved fee that most load and no-load companies use to pay advertising and promotional costs.

  - -- applied annually.
  - -- can be more damaging than a load.
  - -- range from .25% to 1.25%.
  - -- 50% of all funds use this fee.
  - -- sometimes called a hidden load or low load.

- TRANSACTION COSTS: costs that funds incur for buying and selling shares.

  - -- usually low, because mutual funds buy in large quantities.

- OPERATING COSTS: daily operating costs, rent, telephones. Paid from funds assets.

- PORTFOLIO MANAGEMENT FEES: every mutual fund pays a professional management firm to handle investment decisions.

  - -- usually low, because they are distributed across the purchased shares.
  - -- each fund computes management fees differently.
  - -- range from .25% to 1.5%.
  - -- abnormal high fees of 4% or higher could indicate impending failure or poor management.

## Recommendations

The study proved to be important for a number of reasons. First and foremost it was a learning experience starting with a broad topic, mutual funds, and researching a specific area, financial charges in mutual funds. Second, mutual funds are a popular investment source for many consumers and yet the charges discussed can affect the return/yield a considerable amount. Third, the consumer can use the information provided to help plan an investment program, if interested in mutual funds.

The weakest part of this study lies in the presentation of the information. In order to understand the information collected a basic knowledge of mutual funds was important. The tables in the study could be confusing if the information was not understood.

This researcher recommends follow-up studies in the these areas. Each would enhance and improve consumers' education about mutual funds, when combined with the information from this study:

1. Examine the performance of load and no-load mutual funds. Look at how funds were evaluated and performance ratings established. Establish a standard method to evaluate mutual funds.

2. Compare the prospectus disclosure tables in the mutual funds once published in 1989. Is this table providing information useful to the consumer.

3. Examine the prospectus of a mutual fund indepth, and explain what is required from the SEC and what each area means to the investor/consumer.

4. What is the status of the national movement to certify all financial planners and what can a Certified Financial Planner do for the consumer.

5. Are professional planners actually a plus for the investor. Are professional management teams earning more income/returns for the investor.

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VITA

Guy James Wills III

Candidate for the Degree of

Master of Science

Creative Component: CHARGES IN MUTUAL FUNDS AND THEIR EFFECT ON THE INVESTOR'S RETURN

Major Field: Housing, Interior Design, and Consumer Studies

Biographical:

Personal Data: Born in Nagoya, Japan, May 5, 1957, the son of Guy J. and Kimi K. Wills. Married to Judith A. Hewitt on 11 September 1983.

Education: Graduated from Lackland High School, San Antonio, Texas, in May 1975; received Bachelor of Science Degree in Geography from the United States Air Force Academy in May, 1979.

Professional Experience: Completed KC-135 training at Castle AFB, California, in Febuary 1981; reported to Offutt AFB, Nebraska, and flew the EC-135 aircraft from February 1981 to October 1983; assigned to Tinker AFB, Oklahoma from October 1983 until present, flying the EC-135 and the E-3A AWACS. Professional military education includes Distinguished Graduate Squadron Officer's School, correspondence and residence; Air Command and Staff by correspondence.